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A Critique of Loan Targeting and What to Do After Overcoming The Habit

by
Dale W Adams
Professor of Agricultural Economics
The Ohio State University

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Rural Finance Program
Department of Agricultural Economics
and Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210

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AND WHAT TO DO AFTER OVERCOMING THE HABIT

[Loan targeting has been a popular development tool, especially in centrally planned countries, for addressing poverty and to speed development. The results of these efforts, however, have often been disappointing. Three weaknesses of loan targeting are discussed and suggestions are also given on how financial markets might be better used after reforms have subjected most economic decisions in rural areas to market forces.]

Numerous countries are reforming their rural economies by reducing the role of state enterprises and increasing the jurisdiction of market prices. Major adjustments in rural financial markets must accompany these reforms, including dismantling loan targeting. In the discussion that follows loan targeting is critiqued and then suggestions are presented on the role financial markets should play after reform.

LOAN TARGETING

Loan targeting prescribes the characteristics of people who are eligible for loans, dictates the enterprises eligible for credits, specifies inputs that may be purchased with loans, or mandates investments that may be made with credit. Loan targeting is the bread-and-butter of donor agencies, the instinctive reflex of political systems, and the warp-and-woof of financial markets in centrally planned economies. Its most attractive features are the feeling of control it furnishes policy makers and the ease of announcing and implementing such programs. Targeted loans are sometimes accompanied by subsidies, such as concessionary interest rates or casual loan recovery, that are intended to amplify the results of targeting. Credit need is a frequently-used phrase in discussions about loan plans and targets.

Unfortunately, the popularity of loan targeting is not matched by effectiveness. Evidence increasingly shows that loan plans often fail to translate into planned changes in behavior by participants in financial markets, particularly those dealing with agriculture (Von Pischke). While loan targeting may affect behavior of financial market participants in urban areas, along with borrowers of large amounts, it is much less effective in rural areas because of distances from central control and the large number of individuals involved. A donor, for example, may target a loan to fund the installation of a large dam in Brazil and cause a dam to be erected that would not otherwise be built--the donor can insure a large measure of additionality. Control over the ultimate use of loans largely disappears, however, when the government targets fertilizer loans to thousands of farmers in a country such as Ghana through dozens of bank branches. The lending may result in virtually no additionality in the directions desired by the donor when credit is the main policy instrument employed.

Loan targeting has at least three limitations: it attempts to substitute the supposed wisdom of the credit planner for that of loan officers and borrowers; it presupposes that borrowers and lenders can be forced to do things they would otherwise avoid; and it ignores the adverse effects targeting have on the operation of financial markets.

Wisdom of the planner

Targeting presupposes that the wisdom of the planner is superior in two respects to that of loan officers and borrowers. The first is that planners recognize poverty--something that is ignored by participants in rural financial markets. The second is that planners have superior insights and are able to identify high return investments that rural lenders and borrowers overlook.

While rural poverty merits government and donor attention, credit programs may not be the appropriate treatment for poverty. Any subsidy attached to a loan is always proportional to loan size: large loan large subsidy, small loan small subsidy, and no loan no subsidy. Since poor people receive only small loans or no loans, and relatively rich people have more access to loans in general--and especially to large loans--credit subsidies are always distributed regressively by financial markets. If policy makers attempt to subsidize only small loans the financial system has a double incentive to avoid lending to poor people; small loans are the most costly and yield the least revenue per unit of money lent.

The wisdom of credit planners is more apparent than real. Research is increasingly showing that farms are heterogeneous and that rural households are mostly efficient in adjusting to their surroundings and responding to opportunities. If farmers have attractive economic opportunities they will find ways to make investments--witness the coca (cocaine) growers in Bolivia and Peru. An efficient and flexible financial system only assists some of these entrepreneurs to capitalize on opportunities more quickly than they would do otherwise. Too often loan targeting undermines the vitality and flexibility of the financial system and makes it less able to seek out and assist entrepreneurs with the highest return options. If the investment opportunities yield low returns, loans will not make these options attractive, regardless of the subsidies attached to borrowing.

Loan officers and borrowers have more ability to decide on rural projects that merit loan funding than do credit planners in distant cities.

Fungibility

Most parents have experienced telling their children to do something, having them nod in agreement, and then finding later they have done something different. A similar divergence between promise and action occurs in financial markets because of the fundamental attribute of money, its fungibility or interchangeability. Borrowers are willing to agree to whatever loan purpose planners wish to assign, knowing full well that fungibility allows them to use borrowed funds for a variety of purposes. Instead of choosing the investment selected by the loan planner, borrowers ultimately select the most attractive option from among the array of alternatives open to them, including additional consumption.

A credit-fertilizer example illustrates fungibility. Credit planners may decide in Manila, the Philippines that all farmers throughout the country who produce rice need four sacks of fertilizer per unit of land, provide targeted loans to facilitate this, and grant loans in kind to force loan-use compliance. Farmer-borrowers may feel, however, that four sacks of fertilizer are too much on their land, apply only half that amount, sell the remainder in a secondary market, and then spend the receipts from the sale on any activity they wishes. Only when the priorities of the credit planner and the borrower coincide is fungibility not exercised. If priorities coincide there is no need for loan targeting.

Fungibility takes place at all levels of the financial system and within government budgets. Fungibility obviates the possibility of loan planners being able to micro-manage borrower decisions. Planners are self deluded into thinking they control loan allocation and use. What loan officers and borrowers do is often quite different from what credit planners anticipate.

Targeting and performance of the financial system

Loan targeting not only fails to work as intended, but it also weakens the financial system. Extensive loan targeting increases the transaction costs in financial markets, crowds out vital information with data that is useless for bank managers, discourages deposit mobilization, and exposes the financial system to political intrusions and corruption. This causes the formal financial system to service fewer people than it might do otherwise. Even worse, it undermines the bridges between surplus and deficit economic units in rural areas that otherwise would result in more efficient resource allocation.

Extensive loan targeting turns the financial system into a fiscal mechanism that taxes and subsidizes. The addiction to loan targeting is a major reason for formal rural financial markets in many of the low income countries being debilitated in the 1990s. Basing loan decisions on the creditworthiness of the borrower and delegating most of the authority for extending credits to loan officers are the only ways of building durable and efficient financial systems. Policy makers and donors must look beyond the financial system--cheap credit and targeted loans--if they wish to help poor people and find ways of more directly prodding development.

AFTER REFORM

Fundamental economic reforms upset at least five comfortable relationships in rural financial markets: it forces the system to perform new roles; it alters the corporate culture of rural banks; it causes restructuring of the sources and uses of funds; it modifies information flows; and, most importantly, it broadens the client base (Patten and Rosengard).

New roles

Contraction in loan targeting and subsidies usually accompany reform. Increasingly, loans are made on the basis of creditworthiness (the ability to repay) rather than on the basis of need. This results in much less use of credit to lead development efforts and to assist poor people, and much more emphasis on doing efficient financial intermediation. The financial system becomes more of a follower of development rather than a leader. Prices of products and inputs, along with technological change, lead development in a market economy.

This alteration in roles is accompanied by changes in criteria used to evaluate the performance of the financial system. Before reform, evaluations concentrate on what borrowers did with loans. Targeted credit programs are usually evaluated on the basis of number of loans made and extent to which lending quotas are filled. Attempts may also be made to measure the impact of credit use at the borrower level. After reform more attention is paid to the well being of the financial system, to loan recovery performance, to deposit mobilization, to transactions costs, and also to the numbers of people who are served by the financial system, both borrowers and depositors.

Corporate culture

Before reform the financial system pays little attention to its products and services; in large part they are predetermined by those who set loan targets and who prepare loan plans. When farm products and inputs are hived off into private enterprises the rural financial system must alter existing financial services and create new ones. The financial system switches from being supply driven before reform to being demand driven after reform.

Prior to reform rural banks may earn substantial profits from handling farm inputs or products, loan recovery is often assured because of the ties between credit and input or product sales, and many loans are made in kind. After reform the financial system must rely mostly on financial products and services for revenues, loan recovery becomes more problematic, and most loans are made in cash.

To accommodate these changes, rural banks must become more service oriented than they typically were before reforms. Instead of a patronal relationship with their clients, rural banks, after reform, must treat their clients as valued customers. This includes developing new financial products such as deposit instruments, insurance, money transfer mechanisms, and flexible loan contracts.

This change in corporate culture is accompanied by an alteration in the structure of financial institutions. Organizationally, the institutions must become flatter as they move away from loan planning to creditworthy lending. This involves delegating more authority for lending decisions to low levels of the financial system and less control and planning at the top.

Sources and uses of funds

Before reforms most of the loanable funds in rural financial markets are provided by donors, governments, or by commercial banks because of pressure placed on them to allot funds for rural lending, usually on concessionary terms. In many cases, a substantial part of the capital or equity funding for the rural financial system is also provided by government. Because most of the system is supported by government, there is little attention paid to questions of capital adequacy in rural banks.

Many of these sources of funds for rural lending disappear after reform and the money that is available usually carries much higher interest rates. This forces rural lenders to seek additional funds through mobilizing deposits and to also pay more attention to the overall costs of funds. Individuals and firms that wish to draw on these funds for loans must compete by paying competitive interest rates, offering collateral that is acceptable to the lender, and also proving their creditworthiness.

Information flows

Before reform most of the information passing through the financial system responds to priorities of loan planners. The planners transmit information on loan quotas and targets to loan offices and later receive information back from lower echelons of the financial system on the extent to which loan targets were met. Targeting information often crowds out data that would be more useful to bank managers whose objectives are to operate efficient and durable financial institutions. Information is typically available on the number and amount of money dispensed in fertilizer loans, for example, while only cursory information is available on the status of loan recovery.

After reform most of the loan targeting information disappears and is replaced by data that is more useful to those who tend the well-being of banks. This includes bank supervisors and examiners whose job is to protect depositors. It also includes bank managers who are increasingly judged on the basis of profits and losses. This forces managers to seek information on transaction costs, the costs and returns of various sub units and bank products, and to also carefully monitor loan recovery. Modern data processing equipment and skills are required to handle this timely information.

New clients

Seeking new clients is perhaps the most dramatic challenge that reform presents rural financial markets. Prior to reform rural banks largely ignored depositors as important sources of funds. After reform rural banks must solicit funds from depositors who typically are much more numerous than borrowers. Managing these deposits usually requires changes in data processing as banks are forced to handle many more transactions after reform than before.

The privatization and separation of input and product marketing from the financial system also reconfigures the bank's portfolio of clients. Many of the new private agribusinesses should become clients of rural banks. At least some of the farmers who borrowed funds prior to reform may decide not to seek loans from banks after reforms; higher interest rates, the removal of subsidies, and the opportunity to buy and sell goods in private markets will induce some previous borrowers to self finance. Also, some previous borrowers will obtain loans through informal credit that expands with the growth in private marketing.

Many merchants and farmers in virtually all countries find it in their best interests to offer and use informal credit. Merchants use informal loans as a way of attracting clients and are able to efficiently screen creditworthy borrowers because of the information that is available to them through various transactions with borrowers. Farmers are likewise attracted to these arrangements because of modest transaction costs and the flexible loan contracts offered by traders and merchants.

Reforms and changes in clients are a mixed blessing for rural banks. On the one hand, it is relatively easy for banks to deal with the newly emerging agribusiness who are often urban based, educated, have standard collateral, and request large loans. Historically, banks have been more eager to lend to a few traders and merchants than to large numbers of small farmers. On the other hand, reforms force banks to mobilize deposits and to become much more client oriented. Borrowers who must use targeted and subsidized loans to access modern farm inputs, for example, are willing to suffer low quality services from their lender because they have no choice. Savers have many alternative uses for their funds and will only deposit in a bank if services are attractive. Likewise, after reform, informal finance increasingly competes with banks for both loans and deposits.

CONCLUSIONS

The switch from lending based on need to lending based on creditworthiness is a major step for both banks and clients. Under targeting loans are viewed as entitlements that most people should receive, while after reform borrowing is viewed as a privilege that must be earned by proving creditworthiness. The primary problems in target-based lending are dispensing and recovering loans. Creditworthiness lending is a more complicated and diffused system where a major problem for the lender is to screen applicants for loans who are creditworthy from those who are not, and to also offer opportunities for individuals and firms to enhance their creditworthiness. From the individual or firm's perspective, the problem is to establish their creditworthiness with the lender. Acquiring creditworthiness takes time, patience and discipline. It is one of the most important characteristics that sorts successful from unsuccessful financial firms. Constructing a financial system that can perform these important tasks efficiently may be one the most difficult challenges faced in economies that were previously centrally planned.

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